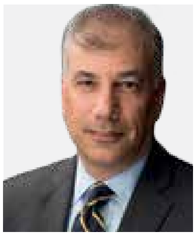
FOCUS ON

# LIQUID ALTERNATIVES

Mark Aldoroty tells *HFMWeek* why leading experts foresee a bright future for liquid alternatives, if the industry can shed more light on its advantages



**Mark Aldoroty** is a managing director for Pershing, a BNY Mellon company. He is a member of Pershing Prime Services Management Committee and leads the prime services sales and relationship management teams. Prior to joining Pershing in 2014, Mr. Aldoroty was a managing director for Citigroup Prime Finance and previously held senior roles at Deutsche Bank and Goldman Sachs, with a career in prime brokerage spanning more than 25 years.

Liquid alternatives look poised for tremendous market growth – but education will be the key to achieving it.

That was the conclusion of leading asset and hedge fund managers who participated in a recent panel discussion hosted by Pershing Prime Services. The event gave Pershing's clients an exclusive, in-depth look at the opportunities and challenges facing the liquid alternatives market today.

Growth will be driven by shifting market winds, the panel noted, as well as by changing investor characteristics. Participants noted the growing concern among investors that the long bull market in fixed income may be drawing to a close, fuelling the demand for alternatives among typical hedge fund buyers as well as traditional fixed income investors. In addition, advisers are now looking to provide more complete portfolio solutions for all of their clients – including those who are ineligible to invest in hedge funds as accredited investors or as qualified purchasers. In fact, many national firms are looking to increase clients' allocations in alternatives from 3%-4% to 15% over the next three to five years. As all these forces converge, the result will be rising demand for liquid alternatives along with a bounty of new offerings.

## EDUCATION WILL BE THE SPARK

Yet, as all participants agreed, education will be absolutely critical to reaching advisers and investors who are still unfamiliar with this new asset class. "Those who educate others can have an advantage," said Bernard Schoenfeld, senior investment strategist, BNY Mellon Wealth Management. Panellists pointed out the educational imperatives ahead, which include:

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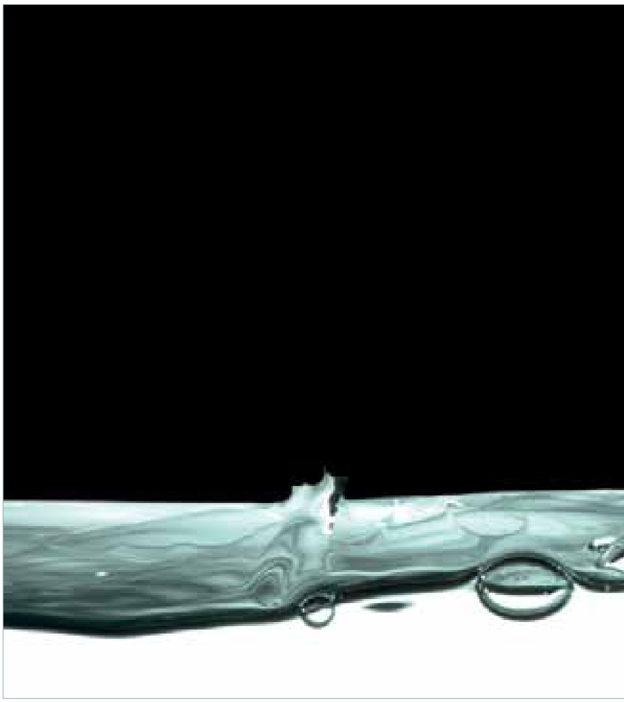

- ***Providing direction to a broader audience of advisers and investors.*** Family offices, institutions and ultra-wealthy investors are already familiar with liquid alternatives. To achieve wider adoption, however, the industry needs to connect with the next level of advisers and private clients. Many traditional fixed income buyers may need to become more comfortable with leaving benchmarks behind. Also, there remain widespread misperceptions to be corrected; for instance, some investors think all fixed income alternatives perform the same way when interest rates rise.

- ***Focusing on what liquid alternatives do, rather than what they are.*** It is a natural tendency for manufacturers and managers to concentrate on defining a solution rather than explaining its function. However, end users care more about what the solution can do for them, how it works together with the other allocations in their portfolio and how it aligns with their risk profile.

- ***Differentiating solutions more clearly.*** The panellists agreed that investors need clearer categories and subcategories to help them distinguish among various types of strategies, so they can better identify the funds that match their goals. Currently, many firms are taking a DIY approach to create their own classification schemes. For example, Joseph Filicetti of Western Asset Management described a way to categorise funds based on their approach to beta. Christine Johnson, managing director – head of alternative product management, Alliance Bernstein, shared the four categories used by Alliance Bernstein to divide the liquid alternative universe: alternative strategic income, true unconstrained, credit long/short and macro. The industry may eventually settle on a single system for classifying liquid alternatives, but investors clearly need more guidance right now.

- ***Clarifying why a manager was chosen.*** A manufacturer looking to launch a liquid alternative solution

> "INSTEAD OF TRYING TO TEACH AN ENTIRE WORKFORCE ABOUT LIQUID ALTERNATIVES, A FIRM CAN FOCUS ON EDUCATING LARGE EMPLOYERS AND THE ADVISERS WHO SERVE THEM"

today can choose from several different methods for finding a manager, such as hiring a sub-adviser, acquiring a firm or developing an internal manager. However, as advisers and investors become more familiar with liquid alternatives, their selection criteria are likely to change. Manager qualifications like hedge fund pedigree, track record and assets under management may become more important. Talented long-only managers could find themselves under greater pressure to prove their ability to manage strategies without a benchmark. Further down the road, once long-term performance data becomes widely available, investors' selection criteria may change again. This process is just one example of the way that education can help expand the market – while also changing the market's dynamics.

- ***Helping investors understand liquid alternatives in a broader context.*** Investors often try to defend themselves against previous downturns. Today they seem most concerned about the liquidity crises of six years ago, as well as the potential reversal in the direction of interest rates. The industry needs to encourage investors to take a step back and understand the role that liquid alternatives can play in a complete portfolio solution – giving them a smoother ride from one end of a market cycle to the other. As Douglas Mangini of Guggenheim Investments pointed out, this is an especially important concept to understand at a time when truly uncorrelated assets are hard to come by, and diversification must often be manufactured.

- ***Segmenting messages by target audience.*** Investors need to be addressed in whatever language they understand. Ultra-wealthy clients are comfortable with alternative assets and already understand how they can help address the risks posed by a changing rate environment. By contrast, investors with smaller portfolios may need their expectations challenged; they may not realise that approaches that have served them well over the last decade may no longer be appropriate over the next three to five years.

Recognising the need for education is one thing – but actually delivering it is another. Panellist Douglas Mangini pointed out the large investment that education can require, calling it a "delivered" experience that is best delivered one-on-one. However, there are ways to make education more efficient. For example, a firm pursuing the defined contribution (DC) plan market might find it cost-prohibitive to educate each individual plan participant. Fortunately, there are other avenues into the DC market that entail less work. Qualified default investment alternatives – such as target date strategies – put investment selection into the hands of the plan sponsors rather than participants. Instead of trying to teach an entire workforce about liquid alternatives, a firm can focus on educating large employers and the advisers who serve them.

Educating investors about liquid alternatives may be a challenge, but, as leading experts at Pershing Prime Services' panel discussion agreed, it is well worth the effort. This is a chance to help rebuild the trust of investors and the potential reward could be a vast field of opportunity, large enough to satisfy every player. ■